AP Microeconomics
Test: Factor Markets
Instructor's Version

Answers: Free-Response Questions

1. Factor Demand

A. Describe how resource prices are determined. (6 points)

Like all prices, resource prices are determined by supply and demand. The demand for a resource is a derived demand—that is, it is derived from the demand for the goods and services produced by that resource. A firm's demand curve for a resource is the marginal revenue product (MRP) curve, which shows the increase in total revenue with the addition of one more resource.

2 points for each sentence.

B. Describe the three main causes of a shift in the derived factor demand curve. (6 points)

1. Changes in demand for the final good or service.
2. Improvements in technology that influence the productivity of some of the factors of production.
3. Changes related to other resources used in the production of the good or service, or change in demand for complementary and substitutable resources.

2 points for each part.

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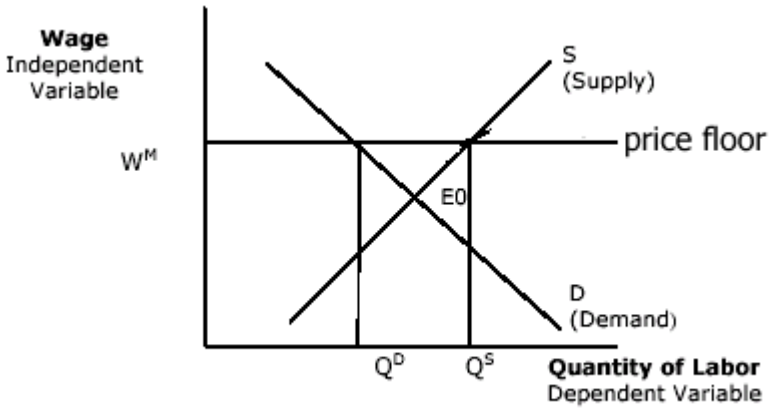
C. Draw a graph, and write out an explanation of what happens when a price floor is set for a factor of production. (4 points) **Give an example of such a price floor.** (2 points)

Graph:



Explanation: A price floor creates a surplus. This is because the quantity demanded at the price above the equilibrium price leads to a lower quantity demanded than quantity supplied.

Example: A minimum wage law is an example of a price floor for a factor of production—in this case, the factor of labor.

Alternate Example: A law that sets a minimum price for a bushel of corn—in this case, corn is a resource used in the production of many goods.

Graph: 1 point for having the price floor above the equilibrium price, 1 point for overall accuracy. Explanation: 1 point for each sentence. Example: 1 point for an example that fits the definition of a price floor, 1 point for an example that is about a factor of production.

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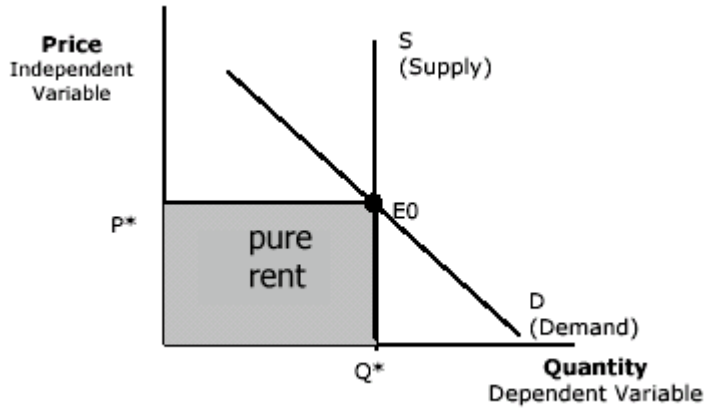
2. Rent and Interest

A. What is pure rent? (3 points) **Draw a graph depicting pure rent.** (3 points)

Pure rent is a type of economic rent, which is the amount of payment a resource earns above its opportunity cost. Pure rent is created when the supply of a resource is fixed. A fixed resource has a perfectly inelastic (or vertical) supply curve.

Graph:



Description: 1 point for each sentence. Graph: 1 point for a vertical supply curve, 1 point for shading the correct area for pure rent, and 1 point for overall accuracy in the graph.

B. How is the quantity of loanable funds that are demanded related to the interest rate? (6 points)

There is an inverse relationship between the quantity of loanable funds demanded and the interest rate. As the interest rate increases, it becomes more expensive to borrow money. Thus, fewer businesses invest in capital.

2 points for each sentence.

C. Define nominal interest rate, real interest rate, and prime rate. (6 points)

The nominal interest rate is the currently posted interest rate. The real interest rate is the nominal interest rate, corrected for inflation. The prime rate is the interest rate that banks charge their largest, most dependable customers.

2 points for each sentence.

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3. Monopsony

A. What is a monopsony? (1 point) **Describe a monopsonistic labor market.** (2 points)

A monopsony is a market with only one buyer. A monopsonistic labor market has only one party that demands labor. Only one large employer hires labor.

1 point for each sentence.

B. How are a monopsony and a monopoly similar? Explain. (3 points)

Answer: Just as a monopolist must charge everyone the same price, the monopsonist must pay every worker the same wage.

Explanation: The monopsonistic firm might have trouble keeping its workers from feeling resentment over the different wages and may find it hard to categorize workers into the different levels of pay they deserve.

2 points for answer, 1 point for explanation.

C. Why do monopsonistic firms tend to hire fewer workers than perfectly competitive firms? (3 points)

The monopsonist recognizes that hiring more workers causes the wages for everyone to increase. This is because the labor supply curve is upward sloping, so to hire more workers, the firm must pay higher wages. Because higher wages are earned by all of the workers, the monopsonist has a higher marginal cost for each worker than a perfectly competitive firm.

1 point for each sentence.

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